

# SECTION 199A – OPPORTUNITIES AND RISKS

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# INTRODUCTION TO THE SEMINAR

- Greetings
- What Is Section 199A?
- The tremendous importance of section 199A to *50 million* American business owners
- For Lawyers and their Clients:
  - What Are the Section 199A Opportunities?
  - What Are the Section 199A Risks?

# THE POWERPOINT SLIDES; MY TAX NOTES ARTICLE

- This webinar is based on my section 199A book.
- I probably won't be able to discuss all of the PowerPoint slides in this webinar
- However, on March 4, visit my website and review my Tax Notes article on computing section 199A pass-through deductions. The URL is [www.llc199A.com](http://www.llc199A.com).
- This article will provide you with a comprehensive explanation of the paramount section 199A issue—how to compute section 199A pass-through deductions.

# INTRODUCTION OF THE SPEAKER

- Speaker's background as relevant to the webinar
  - Current law firm affiliations
  - Current practice
  - Experience in Tax Division and Baker McKenzie LLP
  - Books: *Drafting Limited Liability Company Operating Agreements* and *Maximizing Pass-through Deductions under Section 199A*, both published by Wolters Kluwer Law & Business
- Speaker's website: [www.llc199A.com](http://www.llc199A.com)

# THE ENACTMENT AND EFFECTIVE DATE OF SECTION 199A; OTHER KEY DATES

- Date of Enactment of Section 199A—December 22, 2017
- Effective Date of Section 199A—January 1, 2018
- Possible Expiration Date of Section 199A—End of 2025
- January 1, 2018: Date of Treasury Department Publication of a PDF of final section 199A regulations and a key “Notice” concerning real estate rental businesses

# THE FOCUS OF THIS WEBINAR; TWO KEY SECTION 199A PROVISIONS

- This Webinar Focuses on Section 199A Pass-through Deductions
- Section 199A(a)(2) Is a Cap on Pass-through Deduction Deductions, But It Also Provides a Target for Maximizing Deductions
- Section 199A(b)(2) Is the Default Computation Rule for Pass-through Deductions. Under Section 199A(b)(2):
  - Section 199A(b)(2)(a) Is the “20 Percent of Qualified Business Income” Deduction
  - Section 199A(b)(2)(b) Provides a Deduction That Is the Larger of “50 Percent of Wages” and “25 Percent of Wages Plus 2.5 Percent of Depreciable Business Property”

# THE FINAL REGULATIONS—GENERAL COMMENTS

- Taxpayers Can Still Rely on the Proposed Regulations under certain conditions
- The Proposed and Final Regulations Contain Many Useful Clarifications of Ambiguous Terms in Section 199A Itself—e.g., the Key Term “Trade or Business”
- The Proposed and Final Regulations Contain Several Important Anti-Abuse Provisions—e.g., Concerning the Use of Trusts and the Spinning Off of Qualified Trade Or Business Activities from Specified Service Trade or Business Activities (Proposed § 1.199A-5(c), Discussed Below)
- The Proposed and Final Regulations Contain Several Complex Reporting Requirements Applicable to Trades or Businesses and to Their Owners

# THE THREE MAIN TYPES OF SECTION 199A DEDUCTIONS

Section 199A Provides for Three Main Types of Deductions:

- Pass-through Deductions for Owners of Pass-through Businesses (the Sole Focus of This Webinar)
- Deductions from REIT and Publicly Traded Partnership Income
- Deductions for Farmers and Cooperatives



# WHAT ARE PASS-THROUGH BUSINESSES?

There Are Three Kinds of Pass-through Businesses:

- Sole Proprietorships
  - Can Be Either State-Law Sole Proprietorships or Single-member LLCs Whose Members Are Individuals
- S Corporations
  - Can Be Either State-Law Business Corporations or LLCs
- Entities Taxable as Partnerships
  - Can Be General or Limited Partnerships or Multi-member LLCs. Most Are Multi-member LLCs

# WHAT TYPES OF TAXPAYERS CAN QUALIFY FOR SECTION 199A PASS-THROUGH DEDUCTIONS?

- Qualifying Taxpayers Must Be Owners of Pass-through Businesses
- Qualifying Taxpayers May Be:
  - Passive or Active
  - U.S. or Foreign Individuals Who Pay Federal Income Taxes
  - Trusts and Estates
  - Entities Taxable as S Corporations
  - Entities Taxable as Partnerships
- C Corporations Do *Not* Qualify to Receive Section 199A Pass-through Deductions

# LEGISLATIVE HISTORY OF SECTION 199A; CONGRESSIONAL INTENT

- There Is No Useful Section 199A Legislative History. This Creates Serious Problems of Interpretation.
- The Useless December 2018 “Joint Committee Explanation”
- The basic Congressional intent is clear: “rate parity”
- Other Congressional purposes are Inferable from the Terms of Section 199A:
  - The More Your Taxable Income, the Less Your Pass-through Deduction
  - The More W-2 Wages Your Business Pays, the Greater Your Pass-through Deduction
  - The More Depreciable Real and Personal Property Your Business Owns and Uses, the Greater Your Pass-through Deduction

# EVALUATING SECTION 199A—A PERSONAL VIEW

- The four Congressional purposes reflected in section 199A make sense to me
- The terms of section 199A are needlessly difficult to understand, but they do implement the above purposes effectively and even ingeniously.
- Except for the two “\$25 million” rules in Proposed § 1.199A-5(c), the provisions of the Proposed and Final Regulations are generally reasonable
- Line 9 in IRS Form 1040—misleading?

# THE EXTRAORDINARY COMPLEXITY AND DIFFICULTY OF SECTION 199A

Here Are a Few of the Many Reasons for the Extraordinary Complexity and Difficulty of Section 199A:

- Multiple and Potential Conflicting Purposes
- Confusing Structure
- Impenetrable Taxese
- Novel Terms of Art
- No Useful Legislative History
- The 150 Pages of Proposed and Final Regulations
- The Frequent Need for One or More Types of Restructuring to Maximize Section 199A Pass-through Deductions

# WHAT IS A SECTION 199A “TRADE OR BUSINESS”?

- The Term “Trade or Business” Is Key in Section 199A—But It Is Undefined in the Section
- The Final Regulations Definition—Section 162
- The *Groetzinger*-Based Four-Part Test—Profit Motive; Regular, Continuous and Substantial Business Activity
- The Inherent Vagueness of *Groetzinger*
- Regs. § 1.199A-1(b)(14) (Second Sentence)—a Break for Holding Company-Operating Company Structures
- Notice 2019-7—a Major Break for Owners of Real estate Rental Businesses

# WHAT ARE “SPECIFIED SERVICE TRADES OR BUSINESSES”?

- The Helpfulness of the Final Regulations in Defining Specified Service Trades or Businesses
- Specified Service Trades or Businesses Include the “Classic” Professions in Section 1202(e)(3)(A) Professions—But Not Architects or Engineers
- The Section 1202(e)(3)(a) “Primary Asset “ Test—the Very Pro-Taxpayer “Endorsement,” “Name Licensing” and “Appearances” Definition under the Final Regulations
- Section 475—Investment-Related Professions

# WHAT ARE “QUALIFIED TRADES OR BUSINESSES” AND “EMPLOYMENT SERVICES?”

- What Are Qualified Trades or Businesses?
  - They Are All Trades or Businesses *Except* Specified Service Trades or Businesses and Employment Services
- What Are Employment Services?
  - The Basic “Control” Test
  - The “Burden of Proof” Issue
  - Employee Rental Companies
- Examples of Qualified Trades or Businesses



# COMPUTING SECTION 199A PASS-THROUGH DEDUCTIONS—INTRODUCTION

- The Obviously Key Importance of Knowing How to Compute Section 199A Pass-through Deductions
- The Key Background Provisions
  - Threshold Amount
  - Phase-in Range
  - Wages
  - Qualified Property/UBIA
  - Qualified Business Income

# COMPUTING SECTION 199A PASS-THROUGH DEDUCTIONS—THE SEVEN CATEGORIES, ETC.

- There are seven categories of taxpayers who can receive pass-through deductions.
- The key defining factors for these categories are:
  - Taxable income for the relevant taxable year;
  - Filing status—joint vs. other
  - Federal tax structure
- “Threshold amounts” and “phase-in ranges”

# COMPUTING SECTION 199A PASS-THROUGH DEDUCTIONS—TAXPAYER CATEGORIES 1 THROUGH 3

- Category 1—Definition and Computation Rule (Section 199A(b)(3)(a)); Example
- Category 2—Definition and Computation Rule (Section 199A(b)(3)(b))
  - The Complexity Of Section 199A(b)(3)(b); Summary of Its Provisions
  - Example of Computation for Category 2 Taxpayer
- Category 3—Definition and Computation Rule (Sections 199A(b)(3)(b) and 199A(d)(3)(b)); Example

# SHOULD YOU COMPUTE PASS-THROUGH DEDUCTIONS FOR TAXPAYER CATEGORY 4 TAXPAYERS UNDER SECTION 199A(b)(2)?

## INTRODUCTION

- Category 4—Definition
- The Computation Rule for Category 4 Taxpayers Is Arguably Unclear
- Millions of Taxpayers Are Affected by This Lack of Clarity
- The Content of the *Possibly* Applicable Section 199A(b)(2) –“The Greater of Section 199A(B)(2)(A) and Section 199A(b)(2)(B)”

# COMPUTING PASS-THROUGH DEDUCTIONS FOR TAXPAYER CATEGORY 4 TAXPAYERS—DOES SECTION 199A(B)(2)(B) GOVERN?

- The Arguments for Section 199A(b)(2) as Governing Category 4 Taxpayers
  - The Terms Themselves of the Section
  - The Absence of Any Express Rule to the Contrary
- Example of Application of Section 199A(b)(2) to Category 4 Taxpayers

# TAXPAYER CATEGORY 4—AN ALTERNATIVE COMPUTATION RULE

- My View: The Deduction for Category 4 Taxpayers Should Be Their Section 199A(b)(2)(B) Deduction without Reduction
- The Main Arguments for an Alternative to Section 199A(b)(2):
  - The Intent of Congress in Section 199A Is, in General, to Decrease Deductions As Taxable Income Increases. Thus, Since Section 199A(b)(2) Does Apply to Category 6, It Should Not Apply to Phase-in Categories
  - Since Section 199A(b)(2) Does Not Apply to Category 2, It Should Also Not Apply to Category 4
  - The Intent of Congress in Section 199A Is to Incentivize The Hiring of Employees
  - The “section 199A(b)(2) Phase-in” Argument
- Example
- How Should We Advise Our Category 4 Clients?

# COMPUTING PASS-THROUGH DEDUCTIONS FOR TAXPAYER CATEGORIES 5 THROUGH 7

- Category 5—Definition and Computation Rule (See Discussions Above Concerning Categories 2, 3 and 4); Example
- Category 6—Definition and Computation Rule (Section 199A(b)(2)); Example
- Category 7—Definition and Computation Rule (*No Deduction*); Example

# THE FIVE TYPES OF QUALIFIED TRADES OR BUSINESSES THAT MAY BE TREATED AS SPECIFIED SERVICE TRADES OR BUSINESSES

- Proposed § 1.199A-5(c)—Its Anti-Abuse Purpose
- The Five Rules Under Proposed § 1.199A-5(c):
  - The “\$25 Million or Less” de Minimis Rule # 1
  - The “More Than \$25 Million” de Minimis Rule # 2
  - The “Common Ownership and 80 Percent or More” Rule
  - The “Common Ownership and Less Than 80 Percent” Rule
  - The “Shared Receipts /Five Percent Gross Receipts” Rule



# ADVISING CLIENTS WHO OWN TWO OR MORE BUSINESSES—INTRODUCTION

What Are the Issues?

- Accounting Methods Must Be Reasonable and Consistent
- There Are Special Carry-forward Rules When Some or All of Multiple Businesses of the Same Owner Incur Losses
- “Aggregation”
- Special Issues If There Is REIT and Pass-through Business Income

# AGGREGATION

- Aggregation Under Proposed § 1.199A-4—Definition of Aggregated Businesses
- Aggregation—Who May Aggregate?
  - Owners of Specified Service Trades or Businesses May Not
  - Requirement of Common Ownership
  - Different Owners Can Aggregate Differently
- Aggregation—When Should Taxpayers Aggregate?

# CHOOSING BETWEEN SUBCHAPTER C AND SECTION 199A—INTRODUCTION; C CORPORATION ADVANTAGES

- The Issue of C Corporation vs Section 199A Is An Issue for Every Section 199A Client
- Advantages of Subchapter C
  - The 21 Percent Federal Income Tax Rate Under Section 11(b)
  - Section 1202—Exclusion of Capital Gains in Sales of *Stock* (Not *Assets*) to Third Parties and in Redemptions and Cross-purchases
  - Deduction of Certain Fringe Benefits

# DISADVANTAGES OF SUBCHAPTER C

- No Section 199A Pass-through Deductions of Shareholders' Shares of C Corporation Income
- Section 531—Accumulated Earnings Tax (But with \$250,000 Credit and Certain Other Exceptions)
- Section 541—Personal Holding Company Tax
- The Key Issue Whether You Will Ever Need Compensation or Distributions
- The Key Issue Whether Someday You May Have to Sell Your Company in an Asset Sale

# **THE NEED FOR RESTRUCTURING IN ORDER TO MAXIMIZE SECTION 199A PASS-THROUGH DEDUCTIONS**

- Restructuring Is Often Complex, Difficult and Expensive
- The Frequent Need for Restructuring Is a Major Reason for the Extraordinary Difficulty of Section 199A Practice

# THE MAIN TYPES OF RESTRUCTURING

- Restructuring to *Increase* Taxable Income
  - Get Married So You Can File Jointly!
- Restructuring to *Decrease* Taxable Income
  - Contributions to IRA's, Etc.
- Change from Joint Filing Federal Tax Returns to Separate Filing
- Statutory Conversions of Non-LLC Entities to LLCs
- Turning Current Operating Company into Holding Company and Creation of New Operating Company

# RESTRUCTURING OF S CORPORATIONS AS SOLE PROPRIETORSHIPS OR PARTNERSHIPS

- May Be Necessary When Business Owners' Taxable Income Doesn't Exceed their Threshold Amount—The S Corporation “Reasonable Compensation” Issue
- Restructuring as Sole Proprietorships
- Restructuring as Partnerships—Should Your Spouse Be Your Partner?
- The Potentially Major Prop. Reg. § 1.1402(a)-2 Benefits for Partners

# RESTRUCTURING SOLE PROPRIETORSHIPS AND PARTNERSHIPS AS S CORPORATIONS

- When to Do This Restructuring
  - Business Owners' Taxable Income Exceeds Their Threshold Amount
  - Thus, Their Businesses Need to Maximize Their W-2 Wages to Maximize Their Owners' Section 199A(b)(2)(B) Deduction
- When to Transfer Operations of Existing Business Entities to New Entities



# SECTION 199A PRACTICE AS A LEGAL AND TAX SPECIALIZATION--INTRODUCTION

- What Do We Mean by a Legal or Tax “Specialization”? There Is No Commonly Accepted Definition
- However, the Most Common Characteristics of Specializations Are These:
  - Extensive, Complex and Difficult Material, Which You Can Master Only Through Many Hours of Study and Practice
  - Often Multi-Disciplinary
  - Requires Daily Monitoring of Developments in the Field of Specialization
  - Substantial Number of Potential Customers—You Can Make a Living from This Specialization

# IS SECTION 199A PRACTICE A “SPECIALIZATION”?

- Yes, section 199A practice is a specialization.
- The very close relationship between section 199A practice and LLC practice. Although they are very different areas of practice:
  - They are profoundly interdependent
  - They strongly support each other.
- Lawyers shouldn't form LLCs unless they are section 199A experts or work with section 199A experts.
- Lawyers should advise clients under section 199A unless they are LLC experts or work with section 199A experts.
- One-stop shopping is best.

# WHAT, IF ANYTHING, SHOULD NON-TAX PROFESSIONALS TELL THEIR CLIENTS ABOUT SECTION 199A PASS-THROUGH DEDUCTIONS—INTRODUCTION

Who Are “Non-tax Professionals”?

- Lawyers Who Lack Federal Income Tax Expertise But Who Have Clients Who Are Business Owners
  - These May Include Estate Planning Lawyers, and Corporate Lawyers
- Financial Advisers
- Bankers

# WHAT NON-TAX PROFESSIONALS SHOULD TELL THEIR BUSINESS OWNER CLIENTS ABOUT SECTION 199A PASS-THROUGH DEDUCTIONS

They Should Tell Them That:

- Under Section 199A, These Owners Can Get Deductions of 20 Percent or More of Their Shares of the Net Business Income of Their Businesses
- Unfortunately, Section 199A Is Extremely Complex
- Section 199A Often Requires Significant Restructuring in Order to Maximize Business Owner Pass-through Deductions
- Business Owners Should Consult with a Section 199A Expert!